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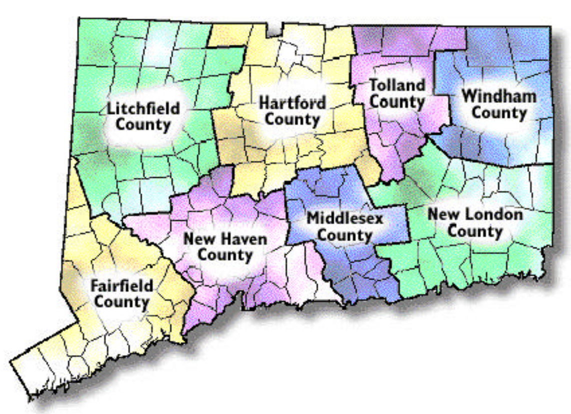
Connecticut Economic Conference Board

Report to the Governor and General Assembly

2001



The Connecticut Economic Conference Board

Annual Report
To the Governor and General Assembly

2001

The Status and Outlook for
The Connecticut Economy

Hartford, Connecticut
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State of Connecticut
Department of Economic and Community Development

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Section 1

Executive Summary: Major Themes

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Executive Summary

Pursuant to Public Act 96-252, the Connecticut Economic Conference Board held an economic outlook conference January 30, 2001 at the Connecticut Economic Resource Center, Rocky Hill, Connecticut. The 9:00 a.m. to 12:00 noon session featured a panel of experts on the economic outlook and an update on the industry clusters initiative. The following text summarizes those proceedings.

The consensus calls for significantly slower but continued overall growth for the U.S. and Connecticut economies. As the current national economic expansion reaches an unprecedented 10^{th} year, there is concern that signs of a slowdown are real and that the slowing national economy seems likely to impact Connecticut. Such a slowdown in growth would not necessarily imply an outright down turn. Slower, more sustainable growth, without the risk of inflation may even be a positive development.

Connecticut's economy in recent years has shown remarkable resilience especially in the past year while signs of a slowing national economy loomed most ominously in the last quarter of 2000. The state's economic strengths such as continued gains in employment, the lowest unemployment rate in the nation, the highest per capita income level for over a decade, favorable quality of life, high educational attainment, budget surpluses, and high productivity are among the factors contributing to a positive outlook. Recent declines in housing permits, the tightness of the labor market, and decreases in consumer confidence that came after a series of six interest rate increases by the Federal Reserve cause concern.

The Federal Reserve (Fed) reversed course on January 3, 2000 and decreased its key interest rate. The surprise rate decrease came between regularly scheduled meetings and the Fed decreased the rates again at its January 30-31 meeting. Fed Chairman Alan Greenspan even intimated that the national growth rate was likely "close to zero" thus underscoring the concerns underlying the Fed's own actions in reversing course. While lower interest rates attempt to accelerate a slowing economy, speeding up the economy can eventually also have the effect of pushing interest rates higher. Thus, monetary policy plays an important role in sustaining the current expansion.

Consumer confidence, however, is viewed as a most important determinant, in addition to income and wealth, of consumer spending. If swift Fed action and the effect of a tax cut give a psychological boost to consumer confidence that could sustain the expansion. That might offset a "wealth effect" (stock market losses decrease consumer spending) where poor stock market performance and disappointing corporate earnings reduce consumer spending, which accounts for about two-thirds of the gross domestic product (GDP).

Connecticut's industry clusters diversify the state's economy. The growth of new and existing clusters contribute to a stronger economy by being less dependent on the still important, but less dominant, industries of defense and insurance.

Section 2

Economic Forecasts

Dr. Ed Deak
Fairfield University

Connecticut enters its ninth consecutive year of economic expansion with the anticipation of 15,000 new jobs added in 2001. Absent a national recession or severe growth pull-back, the New England Economic Project (NEEP) forecast expects Connecticut job gains to continue, averaging 16,000 new positions per year 2001 – 2004. This matches the Economy.com view of a more moderate U.S. expansion. Labor force growth is a critical key to Connecticut job growth.

Connecticut jobs in 2000 were estimated at 1,694,000, up 1.4 percent versus a 2.1 percent U.S. increase. Manufacturing jobs at 264,900 were down 1.3 percent compared with a decrease of 0.2 percent for the U.S. Real personal income of $125.8 billion was up 2.5 percent compared with 3.8 percent for the U.S. The unemployment rate was down 0.9 percentage points to 2.3 percent compared to –0.2 and 4.1 percent for the U.S. Housing permits fell 12.3 percent to 9,329 compared to a decrease of 5.1 percent for the U.S. Population was up 0.2 percent to 3,410,000 compared to a 0.9 percent increase for the U.S. The labor force rose 0.7 percent to 1,706,000 compared to 1.3 percent for the U.S. Gross state product (GSP) in real terms stood at an estimated $134 billion, up 4.8 percent compared to U.S. growth of 4.6 percent.

Connecticut unemployment rates in all ten labor market areas were well under the U.S. rate. Notably, Danbury at 1.2 percent and Stamford at 1.3 percent had the lowest unemployment rates while Bridgeport at 3.0, and Hartford at 3.6, had the highest. The expansion undoubtedly benefited all of Connecticut's major cities.

Significant job changes are expected at the Mohegan Casino (3,500), Pfizer (1,000), UBS Warburg (500), and Cigna (500). But job losses are anticipated at Millstone Power (-600), Philips Medical (-350), and Champion Paper (-315). Residual employment adjustments are also likely at Sikorsky Aircraft, Pratt and Whitney, and Hamilton Sunstrand, reflecting fluctuations in defense, civilian, and government aerospace spending patterns.

Major risks to the forecast include energy price hikes, fallout from the California power crisis, and a Wall Street drop with its implications for the "wealth effect" (a fall in consumer spending as the market declines and portfolios weaken). Finally, consumer confidence remains important to continued spending and future growth.

James Griffin
Aeltus Investments

Connecticut is not in a recession, nor should we anticipate one. Although rolling re-adjustments continue as seen in the 1990s, the ten-year national expansion moves forward. Sectoral "spasms" do not signal a general decline. Fed Chairman Alan Greenspan eased rates as a result of financial markets and to keep consumption from being affected by any "market meltdown." The two 50-basis point cuts in Fed rates are corrective measures, as the Fed signals to the market what is coming.

The fourth quarter slide in consumer confidence was not typical of recession. Prospective tax cuts and low inflation rates are major positives in the outlook. A "peace dividend" from the end of the Cold War brought surpluses to the federal budget. Federal politics turned pragmatic as former President Clinton succeeded in pulling Democrats from "the left" and current President Bush in pulling Republicans from "the right." The consequent social surplus allows simultaneous debt paydown *and* tax cuts.

A remarkably positive view of the U.S. future contributes to this upbeat economic outlook. High productivity, high wealth generation, and high-tech industry have been hallmarks of Connecticut's economy too. So, if first quarter numbers go up, despite some sectoral "spasms," Connecticut will do well.

A "Calvinist view" that the experience of the last ten years has been too good, and now we must "pay the price" is not warranted. The constraints of a deficit, inflation, and regulation are gone. The current global, high-tech, and interdependent capital markets have a "new, more dynamic rhythm." While personal saving is negligible, national saving is sufficient to indicate that we are feeding the federal government surplus "at our own risk."

In conclusion, any "tech sector corrections" can be handled within the overall continuing expansion. We should expect continued growth for both the U.S. and Connecticut.

Eric Olsen
Leif H. Olsen Investments

There is currently nothing to push us into recession. Talk of "weakness" is overdone. The Fed is overly pro-active. Interestingly, the Fed cut rates to keep the economy expanding, yet an expanding economy may itself push rates higher.

Consumption is the important variable. Consumer spending represents two-thirds of Gross Domestic Product (GDP). A weakness in retail sales signals a problem, but we should not expect this as consumption will likely pick up. There is a slightly negative correlation between price/earnings (P/E) ratios and consumption, indicating that they might move in opposite directions. Consequently, a reduction in P/E ratios does not indicate a de-stabilizing effect.

Manufacturing is in recession now, however. This is an over capacity cycle and the downturn in manufacturing is characterized by an inventory build up similar to the 1929 crash, but the Fed's response now is exactly the opposite of the historic depression era response. The Fed's monitoring of the money supply is on target.

The broader money supply known as M-2 grew through 1998. While there has been a more recent decline in M-2 as a result of Fed tightening, it has been relatively stable. Therefore no liquidity constraints are foreseen. GDP growth may fall below 4 percent, but that is not bad in that it will keep inflation in check.

Europe takes its queue from the Fed and European central banks should ease. Meanwhile the U.S. "capacity bubble," causing a problem in manufacturing, must be "worked off." Otherwise, we will see "weak and volatile markets for all of 2001." Investment in emerging markets should still be rewarding.

Connecticut may experience layoffs, even if the market recovers. Fairfield County is particularly vulnerable, given its role in the financial markets. U.S. economic growth should be in the 2 percent range for a few quarters.

Overall, we are reasonably optimistic. Growth in consumption will be the most important variable to watch.

Bruce Blakey
Northeast Utilities

In Connecticut, energy expenditures, according to the U.S. Department of Energy/Energy Information Administration (DOE/EIA), are dominated by oil ($3.61 billion) for gasoline and space heating, followed by electricity ($2.99 billion), and then natural gas ($0.93 billion). By class, residential energy consumption in Connecticut is in the lead at $2.39 billion, followed by transportation ($2.37 billion), commercial ($1.70 billion), and industrial ($0.80 billion).

Petroleum is roughly 3 percent of GDP, while natural gas is roughly 1 percent. Though 2000 saw a significant increase in both U.S. refiners' acquisition costs and consumer energy prices, energy prices may rise again in 2001. The price spikes will do little to companies for whom electricity is only 2 to 3 percent of operating costs. Income does not depend on energy prices and there is adequate capacity. States with high income typically have high-energy prices.

Comparison of U.S. and Connecticut energy sales by class indicates that industrial use is a small percentage in Connecticut. Connecticut's 1999 gigawatthour (GWH) residential sales and commercial sales shares slightly outpaced that for the U.S. In natural gas sales, Connecticut is at the end of the pipeline, as indicated by an increase in the share of sales from Canada and the lack of gas producing wells in New England. Connecticut's industrial use of gas is also much lower than for the U.S. as a whole.

Recent oil prices are up, but not unprecedented. In December 2000, oil prices per barrel were $28.35, down from $34.27 in November 2000, but much lower than the $66.58 price per barrel expressing the 1980 price in 2000 dollars. Likewise gasoline prices of $1.414 in November 2000 were well below the 2000-dollar value of 1980 gasoline prices of $2.326. Thus, the burden of higher gasoline or natural gas prices is generally manageable, and does have a large effect on the Connecticut economy. A 10 percent oil price change costs Connecticut roughly $300 million.

Real electric rates have remained relatively flat since 1975, hovering around 9 cents per kilowatt-hour. Moreover, according to Bureau of Labor Statistics estimates, utility costs represent only 6 percent of the average annual expenditures in the household budget, just below the 6.7 percent estimated for "entertainment, tobacco, and alcohol." Purchased electricity represents a small share of value added for most industries outside of, perhaps, primary aluminum production, for example.

The Northeast Utilities system summer and winter peak demands occur mostly in January and July. Capacity to meet these peaks, operational since 1998 has a 12 percent reserve and is expected to reach 37 percent pending new construction and siting approval. New England had 335 generating plants in 1999 with a total generation capacity of 27,100 megawatts (MW).

Major projects increasing infrastructure capacity by approximately 30 percent include the Quebec to Portland, Maine Natural Gas Transmission System, the Atlantic LNG Project shipping LNG from Trinidad, and the Nova Scotia/Sable Island- New Brunswick-Portland, Maine Maritimes and Northeast Pipeline.

Donald Klepper-Smith
New Haven Regional Data Cooperative

We are in the midst of a "bear market" and "it is not over." The odds of a recession – two consecutive quarterly declines in economic output – are at 40 percent and rising.

It boils down to consumer confidence. That will determine whether businesses continue to invest in equipment, labor continues to be in demand, investors continue to invest, and consumers continue to spend.

Real GDP still has some momentum. Despite a growth rate exceeding 4.0 percent in 2000, the forecast is for less than 2.0 percent growth in 2001. Inflation picked up mildly to around 3.5 percent in 2000, but it is expected to be 4.5 percent in 2001 with an "oil shock" now a real concern. Global growth improves with higher demand for capital implying higher interest rates.

Risks rising include the Fed's over tightening, an aging business cycle, stock market concerns, and high levels of consumer debt. The leading indicators are down three consecutive months generally points to a downturn. Since 1950, when all four of the following criteria have been met, recession has arrived within 12 months. These are: (1) 10-year bond yields are more than 50 basis points below 3-month treasury bill rates, (2) Standard and Poor's 500 index has registered a decline of 20 percent, (3) jobless claims rise by more than 20 percent year-over-year, and (4) Purchasing Managers Index falls below 45. Other concerns are a "wealth-effect" induced drop in consumer spending and problematic high consumer debt.

The People's Bank Business Barometer is a coincident indicator of economic activity within Connecticut. The measure is formed from three statewide series: manufacturing production, non-manufacturing employment, and real disposable income. The current reading indicates slower growth ahead. While the Connecticut economy rose 1.7 percent in 2000, it is projected to rise 0.5 percent in 2001. Real GDP can be expected to rise 1.5 percent in 2001.

Recent developments are not encouraging as housing permits lagged badly relative to job growth. Connecticut's job gains have lagged other New England states. The annual percent change in Connecticut nominal personal income has leveled. The "misery index" (sum of inflation and unemployment rate) should affect stocks in both 2000 and 2001.

In summary, the U.S. economy is slowing and risks to the current domestic expansion are rising. The Fed has over-tightened and is now easing. The aging business cycle, stock market concerns, and rising level of consumer debt are warnings. For 2001, "it's all about the confidence of investors, consumers, and businesses." Finally, because there is no "overhang" in banking, defense, and housing, as in the past recession, Connecticut should do relatively well when it arrives.

<u>Section 3</u>

Industry Clusters Update

Mark Prisloe and Carmen Molina-Rios
Connecticut Department of Economic and Community Development

Connecticut's economic development strategy is to foster the growth of industry clusters. A cluster, according to Harvard Business School Professor Michael Porter, is a geographic concentration of companies and industries that share common markets, products, suppliers, trade associations, and educational institutions. A cluster is "activated" when companies come together as a formal organization.

Six clusters are already launched or activated in Connecticut. Bioscience is overseen by CURE (Connecticut United for Research Excellence). Software/Information Technology is managed by the eBizCT partnership of the Connecticut Technology Council. The Aerospace Cluster is led by the Aerospace Components Manufacturers (ACM) group. Metal Manufacturing is under the direction of META (Metal Manufacturing Education & Training Alliance). Tourism is run by the DECD's Tourism Office. On January 31, 2001, the Connecticut Maritime Cluster under the direction of the Connecticut Maritime Coalition was launched.

Numerous gains of the existing clusters attest to the success of the industry cluster approach. Bioscience now employs 11,000 with $2.2 billion in research and development (R&D) investment. Aerospace manufacturers have promoted workforce development, progressive manufacturing, and consolidated purchasing. Software and Information technology helped rank the state fifth in access to high speed Internet, ahead of California, New York, and Texas per findings of the American Electronics Association. Metal Manufacturing began as a consortium of companies in Bridgeport under Connecticut's Inner City Business strategy in collaboration with the Initiative for a Competitive Inner City (ICIC). The Maritime Cluster boasts 22 members and is positioning the industry in the global marketplace. A Plastics Cluster was due to be launched in February and State agriculture/aquaculture leaders completed a strategic plan.

Cross cutting issues are also being addressed. The Connecticut Business Training Networks adds to active workforce development initiatives. ICIC is the "first-of-its-kind" effort in the nation to address wealth and income growth of inner city residents in five cities simultaneously. Transportation, especially renewed investment and coordination in marketing and managing Bradley International Airport, links Connecticut to the global economy. Marketing Connecticut is being promoted by the "You Belong in Connecticut" campaign.

Key legislative accomplishments include the 1998 "Cluster Bill," extending the six percent R&D investment incentive and allowing small companies to carry forward net operating losses for 20, rather than 5 years, making Connecticut much more competitive among the 50 states. The Governor's Council for Economic Competitiveness and Technology, which oversees the cluster initiative, recommends to the Governor and the legislature that they continue to provide strong support for the industry cluster initiative. The Governor's Council is co-chaired by the Governor and James C. Smith, Chairman and CEO, Webster Bank.

As stated in the ***Industry Clusters Progress Report February 2001***, "the principal mission of the Governor's Council is to promote innovation, productivity, and the competitiveness of our businesses and workforce. Significant strides are being made to accomplish these challenging and critically important goals."